No. 13,731

In The United States Court of Appeals

For the Ninth Circuit

UNITED STATES OF AMERICA,
Appellant,

v.

ARTHUR R. KINTNER and ALYCE KINTNER,
Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MONTANA

BRIEF FOR THE UNITED STATES

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Assistant Attorney General.

Ellis N. Slack,

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OPINION BELOW

The memorandum opinion of the District Court (R. 61-71) is reported at 107 F. Supp. 976.

JURISDICTION

This appeal involves federal income taxes for the year 1948 in the total amount of $780.13 plus interest. The taxes in controversy were paid to the Collector of Internal Revenue for the District of Montana on September 11, 1950. (R. 72.) On or about September 20, 1950, taxpayers filed a claim for refund, and after the expiration of six months from the date of filing of such claim and

within the statutory period of limitations (Section 3772(a) of the Internal Revenue Code), taxpayers instituted this suit for refund in the District Court of the United States for the District of Montana. (R. 73.) Jurisdiction was conferred on the District Court by 28 U. S. C., Sec. 1340. Judgment was entered for the plaintiffs on October 9, 1952. (R. 83-84.) Within sixty days and on December 5, 1952, a notice of appeal was filed. (R. 84.) The jurisdiction of this Court is invoked under 28 U. S. C., Sec. 1291.

QUESTIONS PRESENTED

1. Whether the taxpayer,[1] a doctor practicing medicine as a member of an "unincorporated Association," is taxable on his full proportionate share of the net earnings derived by the Association from the medical services rendered by the member-doctors, including the share of net earnings for the taxable year set aside as a "reserve" by the Association for future expenses.

The answer depends on whether the Association is to be treated for federal income tax purposes as a corporation and its members as shareholders, as the Distirct Court held, or as a partnership composed of the doctor-members, as the Government contends.

2. Whether an amount contributed by the Association to a pension trust for the benefit of the taxpayer as an "employee" of the Association is taxable to him in the year in which the contribution was made.

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[1] Alyce Kintner, taxpayer's wife, is a party because joint returns were filed. (R. 72.) For convenience future references will be made only to the husband, as the "taxpayer."

(a) If the Association constitutes a partnership for tax purposes (as contended by the Government) then the contribution concededly is taxable to the taxpayer as part of his share of the partnership net earnings.

(b) If the Association is deemed a corporation of which the member-doctors are shareholder-employees (as the District Court held) the includibility of the contribution in taxpayer's income for the taxable year depends upon the answer to the following question:

Whether the pension plan meets the exemption requirements of Section 165(a) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra.*

STATEMENT

The facts as found by the District Court (R. 61-63, 72-80) may be summarized as follows:[2]

The taxpayer is a medical doctor practicing his profession in Missoula, Montana. For many years prior to June 30, 1948, he was a member of a co-partnership which practiced medicine under the firm name of Western Montana Clinic. On that day the partners dissolved the partnership and executed "Articles of Association" whereby they purported to become members of an unincorporated association (hereafter referred to as the "Association") for the practice of medicine under the same

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[2] The "Findings of Fact" (R. 72-80) are a replica of the findings as proposed by the plaintiffs below, and embody numerous conclusions of law. Only their factual content is summarized in the statement.

name. The assets and liabilities of the predecessor partnership were taken over by the Association, which thereafter carried on the same activities previously carried on by the partnership. All but two of the employees of the predecessor partnership became employees of the Association. (R. 62, 73-75.)

The Articles of Association (R. 12-28), incorporated by reference in the District Court's findings (R. 74), provided that the members "associate themselves together for the practice of medicine and surgery as an unincorporated Association," which was to be endowed with the "attributes of a corporation" and to be "treated as a corporation for purposes of taxation." (R. 12-13.) The Association was to terminate upon the death of the last survivor of the original members. (R. 13.) The original "members" of the Association were the eight doctors who were the members of the predecessor partnership, and only physicians or surgeons duly licensed to practice medicine in Montana were eligible for admission to membership. (R. 14-15.) The affairs of the Association were to be managed by an executive committee composed of five of the members, who were to select officers, and any indebtedness incurred by the Association through the act of a member without authority conferred by the committee was chargeable against such member's share of the earnings of the Association. (R. 15-18.) Only the members were to be liable to third parties for professional misconduct. (R. 19.) They were to receive "salaries" fixed by the executive committee, the net earnings of the Association were to be divided among them "in proportion to the salaries of such Members," and "All

sums paid to Members, * * * by way of distribution of net earnings, shall be deemed to constitute compensation to the Members for services rendered during the year." (R. 19-20.) The Association was to collect the "accounts receivable for professional services rendered" by the members, was to furnish them with the equipment needed to render such services, and was to pay "all necessary expenses incident to the practice of medicine and surgery by its Members." (R. 21.) In lieu of receiving an interest in assets of the Association, each member agreed that upon his death or withdrawal he would accept the benefits of a pension plan the cost of which was to be borne by the Association (R. 23-25.) The death or retirement of a member was not to cause a dissolution of the Association (R. 26), and the interest of a member was "non-assignable" (R. 27).

The Association was formed by the former partners to enable some rather than all of them to manage its affairs, and to avoid the necessity of a reorganization of the partnership upon the death of a member. (R. 73-74.) Since its formation the Association has operated in accordance with the articles of association. Its affairs have been managed by an executive committee composed of some of the members, while officers chosen by the committee have handled minor details of management. Taxpayer was elected its president. The Association rented in its name space for use in the practice of medicine; employed the services of non-member doctors and other employees; collected in its name the fees earned for

medical services rendered by its members and other doctors employed by it; and paid them salaries and all their expenses in practicing their profession. It also paid social security and withholding taxes, for which purposes it included among its employees the member-doctors; and it paid federal corporate income taxes and state corporation license taxes. (R. 75-76.)

The Articles of Association provided for establishment of a pension plan for the benefit of "qualified employees," whereby those who had been "employed by the Association or its predecessor partnership for at least three years and have attained the age of at least thirty years, shall be entitled to retirement benefits." (R. 24.) Immediately upon its formation the Association entered into a pension trust agreement with a trustee-bank. (R. 78.) This agreement provided with respect to eligibility requirements that employees of the Association who were "employees or members" of the predecessor partnership "shall be given credit for such period of membership or employment by such predecessor." (R. 30.) All contributions under the pension plan are made by the Association, and none by the participants. (R. 78.)

During the portion of the tax year 1948 beginning on July 1, 1948, the Association had thirty-eight employees, including as "employees" the eight member-doctors who were the members of the predecessor partnership. Of these, twenty-four (not including the member doctors) were ineligible to participate under the terms of the pension plan by reason of the fact that they had been employed less than three years, and three others were inel-

igible because of the age requirements. Of the remaining eleven persons who participated in the plan, eight were the member doctors, and for purposes of determining whether they had been employed by the Association for at least three years the period during which they had been partners of the predecessor partnership was treated as a period of employment. Only three persons who were not members of the Association participated in the plan. (R. 79-80.)

The Association set up a "reserve" fund on its books during 1948, to cover anticipated operating expenses for future years; and if the Association is to be regarded for federal income tax purposes as a partnership rather than a corporation a share of this reserve amounting to $1,140.82 is concededly includible in taxpayer's income for the tax year 1948. (R. 9-10, 62-63, 72-73.) The Association also made contributions to the pension trust during 1948, of which $976.14 was paid for taxpayer's benefit. (R. 62, 72-73.) Taxpayer did not report either of these amounts in his 1948 tax returns, and the Commissioner added them to his income, resulting in a deficiency determination. Taxpayer paid the deficiency, and after his claim for refund was not acted upon instituted this suit for refund. (R. 72-73.)

The District Court held that the Association was to be treated for federal income tax purposes as a corporation rather than a partnership, and hence that taxpayer's share of the reserve fund set aside by the Association was not taxable to him. It further held that the pension trust met the exemption requirements of Section 165(a)

of the Internal Revenue Code, and hence that taxpayer was not taxable on the amount paid to the trust by the Association on his behalf. (R. 63-71, 80-83.) It accordingly entered judgment for the taxpayer. (R. 83-84.)

STATEMENT OF POINTS TO BE URGED

The District Court erred:

1. In holding that an unincorporated Association formed by a group of doctors for the purpose of practicing medicine is to be regarded for federal income tax purposes as if it were a corporation, rather than as a partnership composed of the doctor-members of the Association.

2. In holding that the pension plan adopted by the Association for the benefit of its eight doctor-members and three employees satisfied the exemption requirements of Section 165(a) of the Internal Revenue Code.

SUMMARY OF ARGUMENT

I.

Taxpayer's status as a member of an unincorporated Association formed to practice medicine is no different for federal income tax purposes than it was as a member of the predecessor medical partnership, and he is taxable on his full share of the net earnings of the Association. Granting as the court below held that the Association was endowed with more of the formal attributes of a corporation than of a partnership, it cannot be regarded for tax purposes as if it were a corporation because the activity in which it purported to engage—the practice of medicine—was not one which could lawfully be carried on by an artificial corporate entity. The federal taxing statute, while not to be circumscribed by local law definitions of partnerships and corporations, does not treat as a corporation an unincorporated organization which is prohibited from incorporating. Furthermore, the net earnings of the Association were derived solely from, and were distributable solely as compensation for, the professional services of the member-doctors, features which render the Association and its members fundamentally different from a corporation and its shareholders.

If (as the Government contends) the Association is a medical partnership for tax purposes, then its pension plan clearly was not for the exclusive benefit of its "employees," as required by Section 165(a) of the Internal Revenue Code, since the plan benefited the employer-partners. But even assuming that the Association must be regarded as a

corporation of which the member-doctors are the shareholders (as the court below held), taxpayer has failed to show that the pension trust meets the several exemption requirements of Section 165(a), and he is therefore taxable on the amount contributed by the Association to th trust on his behalf. Out of thirty-eight employees of the Association (including the eight shareholder-doctors as "employees"), eleven were benefited by the plan, and eight of the eleven were the shareholder-doctors. In holding that the percentage requirements of Section 165(a)(3)(A) were met (and that consequently the alternative non-discrimination requirements of Section 165(a)(3)(B) need not be considered), the court below erroneously treated the eight shareholder-doctors as having been employed by the predecessor partnership while they were its members, and hence as falling within the terms of the plan conditioning eligibility upon at least three years' employment. The error of the court below is compounded by its general "findings" that the plan complies with the other requirements of Section 165(a). Even assuming that the plan satisfies paragraph (3) of Section 165(a), taxpayer still cannot prevail because he has failed to show compliance with the separate and coordinate requirements of paragraphs (2) and (4) of that section.

ARGUMENT

I.

TAXPAYER IS TAXABLE ON HIS SHARE OF THE NET EARNINGS OF THE MEDICAL ASSOCIATION IN THE SAME MANNER AS WHEN HE WAS A MEMBER OF THE PREDECESSOR MEDICAL PARTNERSHIP

Taxpayer, a doctor, practiced his profession in partnership with other doctors until June 30, 1948. (R. 74-75.) On that date, he and his partners entered into an agreement to "associate themselves together for the practice of medicine and surgery as an unincorporated Association which * * * shall be treated as a corporation for purposes of taxation." (R. 12-13.)

The initial question presented is whether taxpayer's proportionate share of a so-called reserve set aside by the Association from its 1948 net earnings is includible in his gross income for that year. Taxpayer's distributive share of this reserve admittedly is taxable to him if the Association is to be regarded for federal income tax purposes as a partnership composed of the member-doctors. (R. 62, 72-73.) On the other hand, if the Association is to be regarded as a corporation and the member-doctors as its shareholders, then this reserve is not taxable to taxpayer unless and until it is distributed to him as a dividend.[3] The District Court concluded that the Asso-

[3] Partnerships are not taxable entities; each partner must include in his individual income his share of partnership net income, whether or not distribution is made to him. Sections 181-187 of the Internal Revenue Code. Corporate earnings are taxable to the shareholders in the year distributed. Section 115(a) of the Internal Revenue Code; Section 29.115-1 of Treasury Regulations 111.

ciation is to be treated as a corporation for tax purposes (R. 63-68), and we submit that its decision is clearly erroneous.

The artificial entity known as a "corporation," although a creature of state law, is recognized for federal income tax purposes as a taxable entity. Internal Revenue Code, Sections 13, 52 (26 U. S. C. 1946 ed., Secs. 13, 52). Moreover, as used in the federal taxing statute the term "corporation" embraces not only business organizations which elect to incorporate under the local law, but unincorporated "associations" which possess the salient characteristics of a corporation. Section 3797(a)(3) of the Internal Revenue Code (Appendix, *infra*); Sections 29.3797-1 and 29.3797-2 of Treasury Regulations 111 (Appendix, *infra*). The taxation of associations in the same manner as conventional corporations is based upon the "resemblance" of the nature and activities of the two organizations. *Morrissey v. Commissioner,* 296 U. S. 344, 357. An unincorporated association which lacks such resemblance is a "partnership" for tax purposes. Section 3797(a)(2) of the Internal Revenue Code (Appendix, *infra*); Section 29.3797-4 of Treasury Regulations 111, (Appendix, *infra*). *Commissioner v. Gerstle,* 95 F. 2d 587 (C. A. 9th); *Commissioner v. Rector & Davidson,* 111 F. 2d 332 (C. A. 5th), certiorari denied, 311 U. S. 672.

Applying the resemblance test laid down in the *Morrissey* case, *supra,* the District judge here concluded that as "between a corporation and a partnership, the association most closely resembles a corporation." (R. 68.) There

could be no quarrel with this conclusion *if* (as in the *Morrissey* and similar cases relied upon by taxpayer) the income-producing activity of the Association were of a kind which might have been carried on by a corporation. The basic fallacy in the District Court's reasoning lies in its assumption that an unincorporated association organized and operated solely "for the practice of medicine and surgery" (R. 12)—an activity which could not be carried on through a corporation even if its members wished to incorporate—may sufficiently resemble a corporation to be taxable as such. As a general rule, the practice of medicine by a corporation is prohibited; neither a corporation nor any other unlicensed entity may engage, through licensed employees, in the practice of medicine or surgery. 41 American Jurisprudence, Physicians and Surgeons, Sec. 20. See *People v. United Medical Service,* 362 Ill. 442, 200 N. E. 157. The laws of Montana, where the instant Association purported to practice medicine, list the purposes for which a corporation may be formed and such purposes do not include the practice of medicine. Montana Civil Code (1935), Sec. 5903. Since taxpayer and his erstwhile partners were prohibited from practicing medicine as shareholders of a corporation, the unincorporated Association of which they constituted themselves the members may not be regarded as a "corporation" for tax purposes merely because it was endowed with some of the formal features of a corporation, such as centralized management and continuity of existence. An unincorporated organization which is prohibited by law from carrying

on its activities as a corporation can never bear the requisite substantial "resemblance" (*Morrissey v. Commissioner supra,* p. 357) to a corporation demanded by the taxing statute, regardless of the number of corporate garments in which it is clothed.

To be sure, the Treasury Regulations state (Section 29.3797-1 of Regulations 111) that the Internal Revenue Code makes its "own classification" of taxable entities, and that "Local law is of no importance in this connection." This obviously does not mean, however, that the federal taxing statute displaces local law for purposes of determining what kind of an organization may be incorporated, for the very right of existence of a corporation is dependent upon local law. All that the regulation can and does mean is that local law is not determinative of whether a business which could be—but is not—incorporated is to be treated for tax purposes as if it were a corporation. The "classification" of an association as a corporation which the Internal Revenue Code makes for tax purposes necessarily presupposes a freedom of election on the part of those associating themselves as to the form of group action to be taken. Nothing in the Internal Revenue Code or the Treasury Regulations may fairly be construed as creating for tax purposes an artificial entity which could not legally be created for other purposes. Since the doctors who here associated themselves as members of the Association were prohibited from likewise associating themselves as shareholders of a corporation, the court below improperly overruled the Commissioner's determination that the Association could not be treated for tax purposes as if it were a corporation.

Quite apart from the fact that the purpose for which the Association was formed was one for which it could not lawfully be incorporated, the Association differs fundamentally from a corporation in that it carries on no "business" as that term is generally understood. A corporation is a business enterprise whose earnings are derived from a combination of capital and labor, and whose net profits are distributable to those who invest the capital. Here the profits of the Association are not derived from a business, i. e., a combination of capital and labor, but solely from professional services.[4] The only capital of the Association consists of the tools and equipment needed by the member-doctors in their rendition of medical services. (R. 21, 75.)

Nor do member-doctors of the Association bear any resemblance to the shareholders of a corporation. Their interest consists solely of a right to receive a portion of the income derived from their collective personal services in carrying on their profession. Thus Article XII of the Articles of Association provides that the net earnings of the Association are to be distributed among the doctor-members in proportion to the salaries fixed for their services and that "All sums paid to Members, * * * by way of distribution of net earnings, shall be deemed to constitute compensation to the Members for services rendered during the year." (R. 20.) Other provisions of the Articles emphasize the dissimilarity between the interest of the member-doctors and that of a shareholder of a

[4] Section 22(a) of the Internal Revenue Code (Appendix, *infra* which defines gross income, refers separately to income from "professions" and from "businesses."

corporation. Whereas the shareholder of a corporation becomes such simply by contributing capital, only licensed doctors may become members of the Association. (Article V, R. 14-15.) Whereas the interest of a shareholder of a corporation is assignable, the interests of the member-doctors are non-assignable. (Article XXVI, R. 27); indeed, upon the death or retirement of a member, he ceases to have any interest in the assets of the Association and is entitled only to pension benefits (Article XXI, R. 23-24.[5]) Whereas a corporation is liable for the acts of its agents, the Association is not to incur liability for unethical acts of member-doctors performed in its behalf. (Article XI, R. 19.) And whereas the life of a corporation does not depend upon the life of its shareholders, the Association is to terminate upon the death of the last survivor of the original members. (Article III, R. 13.)

In substance and effect the Association was but a continuation of the predecessor partnership. The practice of medicine was carried on by the members of the Association in substantially the same manner as it had been carried on by them as members of the partnership. (R. 165-174.) True, after the Association was formed an "Executive Committee" of five of the eight members managed their affairs, instead of the eight members as was the case when they were partners; and the Association was to con-

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[5] While "certificate notes" were issued to the members in exchange for their interests in the predecessor partnership (R. 74), no property was realizable on account of such notes. The court below found (R. 76) that "the capital structure of the Association is unique in that none of the members of the Clinic, either senior or junior, have any presently realizable ownership in the property of the Association."

tinue until the death of the last surviving member, while under the partnership the death of any member would have required formation of a new partnership by the survivors. However, these differences hardly suffice to transform what for tax purposes concededly was a partnership composed of individual doctors into an artificial entity practicing medicine and taxable as a corporation. The Association no more practiced medicine as an entity separate and apart from its doctor-members than did the predecessor partnership. Its net income was but the collective net income of the group of doctors who jointly practiced medicine as its members. The Association collected the fees for the "professional services rendered," out of which it purchased the necessary medical instruments and paid "all necessary expenses incident to the practice of medicine and surgery by its Members." (R. 21.) The balance (net earnings) was distributable to the member-doctors by way of "compensation." (R. 20.) That the members agreed among themselves to permit the Association to withhold a portion of their net compensation as a "reserve" (R. 20) does not relieve them of tax on this portion. Formation of the Association no more served to insulate them from tax liability on their entire net earnings for each taxable year than did formation of the predecessor corporation.

The Government's position on the question here presented has been the same since 1938, when its contrary position was rejected by the Court of Appeals in *Mobile Bar Pilots Ass'n v. Commissioner,* 97 F. 2d 695 (C. A.

5th).[6] It was there held that an association of pilots could not be classified as a corporation for tax purposes notwithstanding that it possessed most of the features of a corporation, including centralized management and continuity of existence uninterrupted by death or withdrawal of a member. Relying upon the *Morrissey* and like cases, the Commissioner contended that the organization was an association taxable as a corporation, and the Board of Tax Appeals (now the Tax Court) sustained him. However, the Court of Appeals reversed, stating (pp. 696-697):

> We do not consider these and similar cases in point for the following reasons.
>
> Pilotage is the performance of personal services requiring the pilot to have the highest degree of skill as a seaman and is controlled by law. Under the law of Alabama, Gen. Acts 81 and 611 Reg. Sess. 1931, pp. 154, 756, before a man can be licensed as a pilot at the port of Mobile he must have a license * * * He must pass an examination before the Alabama Commission to establish his fitness and be an American citizen of good character. * * * For one not licensed to act as a pilot is a punishable offense.
>
> It is not necessary for a man to be a member of an association to practice his profession but in the nature of things it would be impossible for him to operate alone. * * *

[6] An earlier decision in *Pelton v. Commissioner,* 82 F. 2d 473 (C. A. 7th), sustaining the Commissioner's contention that an association of doctors was taxable as a corporation, has not been followed since the *Mobile* decision, which was published by the Commissioner in 1939-2 Cum. Bull. 244. The *Pelton* case was not relied upon by the court below, and in any event is distinguishable from this one in several respects. For example, not all of the income of the association involved in the *Pelton* case was derived from the professional services of its members, part of it being derived from business activities; moreover, the association possessed important corporate features absent here, such as transferability of the interests of the members.

> It is necessary for the pilots to have someone to look after their business affairs such as collecting their fees as it would be impracticable for the pilot to do that personally.
>
> Pilotage is personal service by an individual * * *. But an association of which the pilot is a member, similar to petitioner, is not responsible for his acts. *Guy v. Donald*, 203 U. S. 399, 27 S. Ct. 63, 51 L. Ed. 245.
>
> It would be impossible for petitioner to engage in the business of piloting as an independent contractor. Petitioner does no business except as an agent of its individual members. It owns no property and has no income as an entity. Consequently is not required to pay income taxes as an association. If by mistake it has filed an income tax return estoppel does not result therefrom and it is immaterial what deductions it attempts to take from the income reported. It follows that it was error for the Board to hold that petitioner was engaged in the business of furnishing licensed pilots and is an association taxable as a corporation.

The situation of the doctors who formed the Association here under consideration is analogous to that of the pilots who formed the association involved in the *Mobile* case, and the rationale of the decision in that case applies with full force here. The practice of a profession such as medicine or law is an individual matter. There is nothing to prevent doctors from associating themselves as individuals in the practice of medicine, as taxpayer here did when he associated himself in partnership with other doctors. But there can be no practice of medicine by an

unlicensed artificial entity.[7] Taxpayer's status as a member of the Association was, in substance and taxwise, no different from what it was as a member of the predecessor partnership.

II.

THE PENSION TRUST CREATED BY THE ASSOCIATION DOES NOT MEET THE EXEMPTION REQUIREMENTS OF SECTION 165(a) OF THE INTERNAL REVENUE CODE

Section 165 of the Internal Revenue Code deals with the tax liability of an employees' trust and of the employee-beneficiaries.[8] Section 165(a) (Appendix, *infra*) prescribes the conditions under which the trust is exempt from tax. If the trust meets the several requirements of that section, then under Section 165(b) (Appendix, *infra*), the beneficiary is taxable on the amounts distributed by the trust in the years of distribution, in the same manner as an annuity. If the trust does not meet the exemption requirements of Section 165(a), then under Section 165(c) (Appendix, *infra*) the beneficiary is taxable on the employer's contributions to the trust in the years in which the contributions are made, where the employee's interest is nonforfeitable.

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[7] A corporation or association may of course employ doctors in carrying on permissible activities without engaging in the practice of medicine. For example, a corporation whose members are the public (not the doctors) and which procures for them medical services and hospitalization on a risk-sharing prepayment basis is engaged in a business, not the practice of a profession. See *American Medical Assn. v. United States,* 317 U. S. 519, 528.

[8] Complementary Section 23(p) deals with the deductibility by the employer of amounts contributed to an employees' trust.

Upon its formation the "Association" established a pension trust in which the eight doctor-members (including taxpayer) and three employees were permitted to participate. (R. 78-80.) The amount contributed by the Association in 1948 on taxpayer's behalf was not reported by him as income in that year, on the theory that the trust met the requirements of Section 165(a). (R. 62-63.) The Commissioner determined that the plan did not satisfy these requirements, and the District Judge overruled his determination. (R. 69-71, 82.)

A. *If the Association is a partnership, the plan is not for the exclusive benefit of its "employees" within the meaning of Section 165(a) since the employer-partners are beneficiaries*

If this Court agrees with our contention (point I, *supra)* that the Association must be regarded for tax purposes as a partnership rather than a corporation, then there is no need to reach and determine the question of whether the pension trust meets the requirements of the various subsections of Section 165(a). In such case the trust would fail to satisfy the opening requirement of Section 165(a) that the employer's plan be "for the exclusive benefit of his employees or their beneficiaries," since it admittedly would benefit the employer-partners as well as the employees of the partnership. I. T. 3350, 1940-1 Cum. Bull. 64. This long-standing administrative ruling, after reviewing the applicable statutory provisions and Regulations, states (p. 65):

> From the foregoing, it appears that such professional partnerships are entitled to the same privileges

as corporations in the establishment of pension trusts for the benefit of the *bona fide* employees of the partnerships. However, it is the view of the Bureau that a general partner, as such, is not an employee of the partnership and is precluded, under the provisions of section 165 of the Internal Revenue Code, as amended, from participating in the benefits of a trust such as is contemplated by that section and by similar provisions of prior Revenue Acts.

B. *Even if the Association is deemed a corporation, the plan fails to satisfy the requirements of Section 165(a)*

Even assuming arguendo that the Association must be regarded as a corporation and the doctor-members as its shareholders, taxpayer still cannot prevail since he has failed to show that the plan meets the requirements of subsections (2), (3) and (4) of Section 165(a).[9] Although the court below held that the plan "complies with all the requirements of Section 165(a)" (R. 71), it dealt only with subsection (3) in its opinion (R. 69-70), Accordingly, we shall deal first with this subsection.

1. *The requirements of Section 165(a)(3) are not met*

Subsection (3) of Section 165(a) prescribes certain coverage and classification requirements, and paragraphs (A) and (B) of this subsection provide alternative methods for meeting them. To qualify under paragraph (B)

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[9] An action on a claim for refund to recover taxes erroneously collected is essentially an equitable action for money had and received and unjustly retained by the United States, and it is incumbent upon the claimant to prove all the elements entitling him to recovery including the amount of overpayment. *Stone v. White,* 301 U. S. 532; *Lewis v. Reynolds,* 284 U. S. 281.

it must be shown that the plan "benefits * * * such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory." No claim has been made by taxpayer that the plan qualifies under paragraph (B), nor would any such claim be tenable since the plan was never approved by the Commissioner. See *Charles E. Smith & Sons Co. v. Commissioner,* 184 F. 2d 1011, 1014 (C. A. 6th), certiorari denied, 340 U. S. 953. Section 29.165-1(c) of Treasury Regulations 111. However, the court below agreed with taxpayer's contention that the plan met the alternative requirements of paragraph (A), and accordingly held that "there is no occasion to consider the plan with reference to subsection (3)(B)." (R. 70.) We respectfully submit that the court below clearly erred in holding that the provisions of paragraph (A) were satisfied.

A plan qualifies under paragraph (A) if it "benefits * * * 70 per centum or more of all the employees, or 80 per centum or more of all the employees who are eligible to benefit under the plan if 70 per centum or more of all the employees are eligible to benefit under the plan, *excluding in each case employees who have been employed not more than a minimum period prescribed by the plan, not exceeding five years.*" (Italics supplied.) The agreement creating the "Association" authorized it to establish a pension plan "whereby all employees of the Association who have been *employed by the Association or its predecessor partnership for at least three years* and have attained

the age of at least thirty years, shall be entitled to retirement benefits" upon reaching age sixty-five. (Italics supplied; R. 24.)[10] Thus in applying the percentage requirements of Section 165(a)(3)(A), employees of the Association who had been "employed" by it or by the predecessor partnership for less than three years must be excluded from consideration.

The District Court found that the Association had a total of thirty-eight employees, including the eight members as "employees"; that of this total, twenty-four (not including the eight members) were ineligible to participate in the plan because they had been employed less than three years; that of the remaining fourteen employees, three were ineligible because of the age requirements; and that the remaining eleven employees—consisting of the eight members of the Association and three non-members—were eligible to and did participate in the plan. On the basis of these findings, it concluded that eleven out of fourteen, or seventy percent of "all" the employees, "excluding those employees who had been employed less than three (3) years," were eligible to participate, and that all those eligible did participate. (R. 79-80.)

In applying the percentage requirements of Section 165(a)(3)(A), the court below properly excluded the twenty-four persons who had not been "employed" by the Association or the predecessor partnership for at least three years. However, it *erroneously omitted also to ex-*

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[10] The plan as adopted departed from the eligibility requirements authorized in the Articles of Association by providing that employees of the Association who were "members" of the predecessor partnership "shall be given credit for such period of membership." (R. 30.)

clude the eight members of the Association who likewise had not been "employed" for at least three years. The period during which the members of the Association were employer-members of the predecessor partnership may not be counted as part of a period during which they were "employed", particularly since the Articles of Association themselves explicitly provide that only those employees of the Association who had been "employed by the Association or its predecessor partnership" for at least three years were eligible to participate. (R. 24.) If the eight members of the Association who were the employer-members of the predecessor partnership are excluded for purposes of applying the percentage requirements of Section 165(a)(3)(A), as they must be, then it is clear that the plan does not qualify. The Association had a total of thirty-eight employees, of whom thirty-two (including the eight member-employees) had less than three years service as *employees* of the Association or the predecessor partnership. The percentage requirement of Section 165(a)(3)(A) is therefore applicable to the remaining six employees.[11] Since three of these were ineligible to participate because of age requirements (R. 79), ony fifty percent of the employees were eligible to benefit under the plan and the percentage requirements has not been met.[12]

2. *The requirements of Section 165(a)(2) are not met*

[11] The District Judge found this number to be fourteen (R. 79), since his computation failed to exclude the eight members.

[12] While all (one hundred percent) of the three employees who were eligible did participate, at least seventy percent of all the employees must be eligible under Section 165(a)(3)(A).

The error of the court below is accentuated by its general "finding" that the plan meets the requirements of subsection (2) of Section 165(a). (Finding XII(b), R. 19.)[13] This subsection specifies that it must be "impossible" under the terms of the trust created by the employer "for any part of the corpus or income to be * * * used for, or diverted to, purposes other than for the exclusive benefit of his employees." A trust instrument which permits the employer even indirectly to control either the investment or the disposition of the trust funds runs afoul of this provision. *Lichter v. Commissioner,* 201 F. 2d 49 (C. A. 6th), certiorari denied, 345 U. S. 942; *Charles E. Smith & Sons Co. v. Commissioner, supra,* p. 1014; Section 29.165-2 of Treasury Regulations 111. See also *South Texas Comercial Nat. Bank of Houston v. Commissioner,* 162 F. 2d 462 (C. A. 5th), certiorari denied, 332 U. S. 772; *Roberts Filter Mfg. Co. v. Commissioner,* 174 F. 2d 79 (C. A. 3d); *Robertson v. Steele's Mills,* 172 F. 2d 817 (C. A. 4th). It was no less possible in this case for the employer to divert the trust funds to purposes other than the "exclusive benefit of his employees, through control of the administration of the trust, than in the *Lichter* and *Smith Co.* cases, *supra.*

The trust instrument here provided that the trust was to be administered by a "Pension Committee" of three members, who were to be appointed by and hold office "during the pleasure" of the executive committee of the employer-Association. (R. 42.) This employer-controlled

[13] This finding embodies the statutory language of Section 165(a)(2), without mentioning the section, and represents a legal conclusion.

pension committee was to "supervise and control the operation" of the plan, and was to have unlimited power to construe the trust instrument and determine all questions affecting eligibility of any employee. (R. 42-43.) Moreover, the trustee could make no investments or disbursements except those authorized by the employer-controlled pension committee. (R. 43, 45.)[14] The trustee could be removed at any time upon notice by the employer (R. 46); and it was to be liable "only for the safekeeping" of documents and to have "no other or further duties" (R. 43). These features alone preclude qualification of the trust under Section 165(a)(2). In the *Smith & Sons Co.* case, *supra*, p. 1014, the court held that a pension trust was not "for the exclusive benefit" of the employees within the meaning of that section because one of the three trustees was the president and stockholder of the employer-corporation. The court said (p. 1014) that "As one of the three trustees administering the trust, the two other trustees being employees, he was in sole control not only of the corporation, but of the trust." In the *Lichter* case, *supra*, the court likewise held that the trust did not qualify under Section 165(a)(2) because an advisory board consisting of three members appointed by the employer controlled the acts of the trustees. The instant case presents an *a fortiori* situation for holding that the trust did not qualify under Section 165(a) as one under which it was "impossible" for any part of the trust fund to be used for purposes other than the "exclusive benefit" of the employees.

[14] Neither the pension committee, the trustee, nor the employer was to be held responsible for the investments selected. (R. 38-39, 43, 44-45, 47-48.)

3. *The requirements of Section 165(a)(4) are not met*

Equally unfounded is the general "finding" by the court below that the plan meets the requirements of subsection (4) of Section 165(a). (Finding XII(d), R. 80.)[15] Under this portion of Section 165(a), it must be shown that the "benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders * * *." If as the court below held the Association is to be treated as a corporation, then the eight doctor-members are in effect its "shareholders," and the conclusion is inescapable that the plan discriminated in their favor. The plan as adopted authorized crediting the shareholders as *employees* of the Association with the period during which they were employer-partners in the predecessor partnership (R. 30), so as to make them immediately eligible for participation in the plan as "employees" having at least three years' service. As a consequence, contributions were made by the Association on behalf of the shareholder-employees for at least three years prior to the date contributions would have been made had they been subject to the same standards of eligibility that existing and future non-shareholder employees were required to meet.

The pension provided by the plan is "a monthly pension amounting to one and one-half per cent (1½%) of the monthly salary of the employee for each year of service of such employee (not to exceed thirty years' service) be-

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[15] This finding embodies the statutory language of Section 165(a)(4), without mentioning the section, and like finding XII(b) represents a legal conclusion.

tween the date of first participation by the employee and the employee's retirement date." (R. 33.) By permitting the shareholder-employees to participate three years prior to the date they could meet the standards applicable to non-shareholder employees, the plan discriminated in favor of the shareholders by according each of them a pension at least four and one-half percent greater than that accorded other employees having the same number of years of service and the same salary. This discriminatory feature of the plan becomes even more pronounced when it is remembered that only eleven out of thirty-eight employees were allowed to participate immediately, and that eight of these eleven participants were the shareholders. (R. 79-80.) Cf. *Charles E. Smith & Sons Co. v. Commissioner, supra,* p. 1014.

In short, even if the Association is deemed to be a corporation rather than a partnership for tax purposes, and the doctor-members are regarded as shareholders rather than as partners, it was error for the court below to hold (R. 71) that the pension plan of the Association "complies with all the requirements of Section 165(a)." The plan failed to comply with the requirements of subsections (2), (3) and (4) of that section.

CONCLUSION

The decision of the District Court is erroneous and should be reversed.

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APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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(26 U. S. C. 1946 ed., Sec. 22.)

SEC. 165 [As amended by Sec. 162(a), Revenue Act of 1942, c. 619, 56 Stat. 798]. EMPLOYEES' TRUSTS.

(a) *Exemption from Tax.*—A trust forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall not be taxable under this supplement and no other provision of this supplement shall apply with respect to such trust or to its beneficiary—

(1) if contributions are made to the trust by such employer, or employees, or both, for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in acordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus

or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries;

(3) if the trust, or two or more trusts, or the trust or trusts and annuity plan or plans are designated by the employer as constituting parts of a plan intended to qualify under this subsection which benefits either—

(A) 70 per centum or more of all the employees, or 80 per centum or more of all the employees who are eligible to benefit under the plan if 70 per centum or more of all the employees are eligible to benefit under the plan, excluding in each case employees who have been employed not more than a minimum period prescribed by the plan, not exceeding five years, employees whose customary employment is for not more than twenty hours in any one week, and employees whose customary employment is for not more than five months in any calendar year, or

(B) such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees;

and

(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

* * *

(b) *Taxability of Beneficiary.*—The amount actually distributed or made available to any distributee by any such trust shall be taxable to him, in the year in which so distributed or made available, under section 22(b)(2) as if it were an annuity the consideration for which is the amount contributed by the employee, except that if the total distributions payable with respect to any employee are paid to the distributee within one taxable year of the distributee on account of the employee's separation from the service, the amount of such distribution to the extent exceeding the amounts contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months.

(c) *Treatment of Beneficiary of Trust Not Exempt Under Subsection (a).*—Contributions to a trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 165(a) shall be included in the gross income of an employee for the taxable year in which the contribution is made to the trust in the case of an an employee whose beneficial interest in such contribution is nonforfeitable at the time the contribution is made.
(26 U. S. C. 1946 ed., Sec. 165.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by some means of which any business, financial operation, or venture is carried on, and

which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

(3) *Corporation.*—The term "corporation" includes associations, joint-stock companies, and insurance companies.

* * *

(26 U. S. C. 1946 ed., Sec. 3797.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.3797-1. *Classification of Taxables.*—For the purpose of taxation the Internal Revenue Code makes its own classification and prescribes its own standards of classification. Local law is of no importance in this connection. Thus, a trust may be classed as a trust or as an association (and, therefore, as a corporation), depending upon its nature or its activities. (See section 29.3797-3.) The term "partnership" is not limited to the common law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships. (See section 3797-4.) The term "corporation" is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, an insurance company and certain kinds of partnerships. (See sections 29.3797-2 and 29.3797-4.) The definitions, terms, and classifications, as set forth in section 3797, shall have the same respective meaning and scope in these regulations.

Sec. 29.3797-2 [as amended by T. D. 5468, 1945 Cum. Bull. 332.] *Association.*—The term "association" is not used in the Internal Revenue Code in any narrow or technical sense. It includes any organization, created for the transaction of designated affairs,

or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, a joint-stock association or company, a "business" trust, a "Massachusetts" trust, a "common law" trust, an interinsurance exchange operating through an attorney in fact, a partnership association, and any other type of organization (by whatever name known) which is not, within the meaning of the Code, a trust or an estate, or a partnership.
* * * * * *

* * *

Sec. 29.3797-4. *Partnerships.*—The Internal Revenue Code provides its own concept of a partnership. Under the term "partnership" it includes not only a partnership as known at common law, but, as well, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any business, financial operation, or venture, and which is not, within the meaning of the Code, a trust, estate, or a corporation. On the other hand the Code classifies under the term "corporation" an association or joint-stock company, the members of which may be subject to the personal liability of partners. If an organization is not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of its existence, and its management is centralized in one or more persons in their representative capacities, such an organization is an association, taxable as a corporation. As to the characteristics of an association, see also sections 29.3797-2 and 29.3797-3.) * * *